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Financial Markets

Irving Trust

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Friday
(Noon)

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The current watchword for Fed policy is caution. The Fed has been careful with policy for some time: Fed funds (the weekly average rate) broke the 10% level on March 21; and seven weeks later, Fed funds generally are trading only about half a percentage point higher. Other rates have risen much faster, however, with three-month CD rates rising 89 basis points, and 20-year Treasuries rising 67 basis points over the same period. The recent rise in rates has been sharp; the general rising trend dates back to February. As mentioned in last week's letter, there is now a substantial premium of interest rates to the current rate of inflation. However, it is the sharp rise in nominal rates that will lead the Fed to pause and to be cautious.

Over the past several weeks, a variety of incidents have revealed the fragile condition of financial markets. "Unauthorized" trading apparently led to substantial losses at one firm. Also, a government securities-trading tax shelter has fallen on hard times after suffering large losses, presumably due to trading in what has been an extremely treacherous bond market. However, the Fed is likely to turn its head more because of the recent liquidity problems at Continental Illinois. What will attract the Fed's attention the most and cause a policy response is the apparent suddenness with which this problem struck. No single or known event seems to have been responsible--and this is what is disturbing. We seem to have a case of a sudden loss in investor confidence that the Fed fears might be transferable to other organizations. As a result, the Fed acted quickly along with other regulators to cement confidence.

The Fed is charged with, among other things, the maintenance of orderly conditions and well functioning financial markets. When rising rates lead to solvency or liquidity problems, the Fed's monetary policy function may come into conflict with this goal. The Fed then has the choice of backing off with monetary policy or going ahead with it while patching up the financial situation with some structural solution. Generally the Fed will opt to leave monetary policy "on course" and try to use other means to solve the problems of floundering institutions. However, critical to the Fed's actual policy choice is the way in which the problem is perceived. If an institution has purely internally generated problems, the Fed will ignore these for monetary policy purposes. If an institution is being battered by general market forces, the Fed is more likely to swerve in its policy course, especially if these problems seem to be transferable.

Right now the Fed is probably swerving. It will likely put any further upward thrust in rates on hold for at least a week or two, until market conditions become more settled. The Fed must be concerned about investor psychology, which seems to be in bad shape. But while policy will pause here, we can't be certain that the upward move in rates will stop. It is a time for caution, not only to rebuild confidence in the financial system, but also to watch the economy and see if any further tightening might be appropriate.

Robert A. Brusca

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Market Yields

	5/18/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	12.50%	12.50%	10.50%
Effective since	5/8/84		
Discount Rate at Federal Reserve Bank	9.00	9.00	8.50
Federal Funds	9.25	10.63	8.63
Repurchase Agreements	8.63	10.13	8.50
U.S. Treasury Issues			
Bills			
3 months	10.18	10.24	8.43
6 months	10.94	10.85	8.70
1 year	11.66	11.46	8.96
Coupons			
2 years	12.47	12.37	9.58
4 years	12.99	12.86	9.98
7 years	13.38	13.23	10.39
10 years	13.47	13.36	10.48
Long Bond	13.48	13.42	10.64
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.50	11.00	8.55
3 months	11.10	11.40	8.60
6 months	11.70	11.90	8.75
1 year	12.25	12.30	9.15
Banker's Acceptances			
1 month	10.59	11.10	8.46
3 months	11.21	11.47	8.63
6 months	11.86	11.81	8.79
Eurodollar Deposits			
1 month	10.75	11.38	8.94
2 months	10.38	11.75	9.00
3 months	10.69	12.00	9.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.76	10.62	8.51
1 month	10.29	10.75	8.56
3 months	11.05	10.73	8.68
Bank Holding Companies			
1 month	9.93	10.19	8.56
Dealer Placed:			
3 months	11.21	11.36	8.66
New AA Corporate Utility Bond	14.85	14.75	11.40
Tax Exempt			
6 month Project Notes	5.80	5.80	4.75
1 year AAA Bond	6.50	6.25	5.25
5 year AAA Bond	7.80	7.60	6.60
20 year AAA Bond	9.90	9.90	8.50

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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